UNITED STATES DEPARTMENT OF AGRICULTURE
FARM CREDIT ADMINISTRATION
WASHINGTON, D. C.

SUMMARY OF CASES

RELATING TO

FARMERS' COOPERATIVE ASSOCIATIONS

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STATUTE CONSTITUTES MANDATORY OBLIGATION

The opinion of the Court in the case of Farmers Cooperative Company v. Birmingham, 86 F. Supp. 201, covers nearly 35 pages. It contains a great deal of valuable information on the status of exempt and nonexempt agricultural cooperative associations. It refers to many rulings of the Bureau of Internal Revenue and the Treasury Department with respect to exempt and nonexempt cooperative associations.

The Farmers Cooperative Company is a nonexempt agricultural cooperative association. It paid income, excess profits, and declared value excess profits taxes, and then filed a suit against the Collector of Internal Revenue for the district in which the association is located for the recovery of the taxes which it had paid. The question for decision was whether the association was entitled as a matter of law to exclude patronage refunds which it had allocated to its members and which were paid in cash at a later date. The total amount of the patronage refunds or dividends in question was $5,913.14. The cooperative company was originally incorporated under the General Corporation Act of Iowa. It operated during the tax year in question under the General Corporation Act from November 1, 1943, to February 8, 1944, on which date the corporation was reorganized as a nonstock cooperative association.

The Court held that the cooperative was entitled to exclude the savings which it had effected in the conduct of its business from and after February 8, 1944, but held that the amount of the earnings which were made by the corporation prior to its reorganization under the Cooperative Act of Iowa as a cooperative association could not be excluded. In brief, the Court held that $1,450.40, the amount of the ascertained earnings on the business of members prior to the reorganization of the corporation as a cooperative could not be excluded, but that $4,462.74, the amount of the savings effected by the cooperative from and after Februrary 8, 1944, were excludable. The Court held that there was no obligation existing on the part of the corporation to make any refunds during the period that it was functioning under the General Corporation Laws of Iowa, but on the other hand, the Court held that the Cooperative Act of Iowa, under which the corporation was reorganized on February 8, 1944, constituted an obligation to pay patronage dividends or refunds, and hence that such dividends or refunds, representing savings effected on the business of members after that date were excludable.

Although the cooperative did business with nonmembers, no patronage dividends or refunds were paid to nonmembers, and the cooperative did not include the profits made on nonmember business in the refunds that it made to its members.

It is impossible in a brief summary of the opinion in this case to present all the points and propositions which are discussed. The following quotations from the opinion should prove of interest:

"Section 101(12) of the present Internal Revenue Code, 53 Stat. 4, 33, 26 U.S.C.A. § 101(12), establishes the requirements for tax exemption

of cooperatives for federal income tax purposes as follows:

"1. They must be organized by farmers on a cooperative basis.

"2. They must operate as a marketing or purchasing agency on a cost basis, ultimately turning back all net proceeds to member and non-member patrons.

"3. Substantially all stock except nonvoting, nonprofit-sharing preferred stock must be owned by producers or purchaser member patrons.

"4. Dividends may not exceed 8 percent or the legal rate in the state of incorporation, whichever is greater.

"5. Only reserves required by state law, or reasonable reserves for a necessary purpose may be accumulated.

"6. Neither the cooperative nor its member patrons may gain a discriminatory advantage on non-member business.

"7. Non-member business must not exceed member business and purchasing cooperatives are limited in their purchases for non-member [non-producer] patrons to 15 percent of their total business."

* * * * * * *

"The exclusion of patronage dividends for federal income tax purposes is sometimes referred to as being a matter of 'administrative grace' or 'administrative liberality.' It is believed that the use of such terminology makes for confusion, for it is obvious that no official of the Government is vested with the 'grace' or 'liberality' to exclude from a taxpayer's income that which is legally taxable to him under the federal income tax statutes. It would seem that the crucial question involved in determining the taxability of patronage dividends is whether they constitute income to the cooperative, or to the patrons, or to both, similar to the amounts distributed as dividends by ordinary corporations. One writer contends that it is the income of neither. See O'Meara, The Federal Income Tax in Relation to Consumer Cooperatives, 36 Illinois Law Review 60 (1941). The Commissioner of Internal Revenue and the officials of the Treasury Department in a multitude of situations must determine whether particular amounts constitute income and to whom such income is taxable for federal income tax purposes; and that is what they have to determine in the case of patronage dividends. In New Colonial Ice Company v. Helvering, 1934, 292 U.S. 435, 440 54 S Ct. 788, 790, 78 L.Ed. 1348, 1352, the United States Supreme Court stated, ' * * * a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.' See also, White v. United States,

1938, 305 U.S. 281, 59 S. Ct. 179, 83 L. Ed. 172. As noted, there are no applicable statutes providing for the exclusion of patronage dividends for income tax purposes." (Underscoring added.)

* * * * * * *

"If an organization at the time the income was received by it was under no obligation to allocate or distrbute it as a patronage dividend but later did so, it could be claimed that in so doing it was distributing the income by virtue of its command over such income and was in effect the donor of the income." (Underscoring added.)

* * * * * * *

"The mere creation of an obligation to distribute one's income to another does not usually relieve the obligor of tax liability. See Lucas v. Earl, 1930, 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731; Shelley et al. v. Commissioner, 1943, 2 T.C. 62, and other cases having to do with anticipatory assignments of income and trust agreements covering income to be earned in the future, cited supra. If the self-imposed obligation of a cooperative to distribute its earnings as a patronage dividend is regarded as being a valid one and as not falling within the scope of those decisions negativing the efficacy for federal income tax purposes of anticipatory assignments of income, then by virtue of such obligation the cooperative no longer commands the income so obligated. However, if a cooperative distributes its earnings as a patronage dividend without any previous obligation to do so, it could be claimed that in making such distribution the taxpayer was exercising its own command over the income and was in effect acting as donor of the same." (Underscoring added.)

* * * * * * *

"In connection with the matter of the obligation of the taxpayer in the present case to allocate a portion of its earnings as a patronage dividend, it was stipulated that the patronage dividend included the sum of $1450.40 which represented profits derived from transactions with those present members of the taxpayer who transacted business with the taxpayer for the period from November 1st, 1943, to February 8th, 1944, during which time it functioned as an ordinary stock corporation. During that period the obligation of the taxpayer was to pay its stockholders dividends on the basis of their stockholdings rather than to pay members dividends on the basis of their patronage." (Underscoring added.)

* * * * * * *

"Since dividends of ordinary business corporations based upon stock ownership are not excludable from the gross income of such corporations for federal income tax purposes, it would seem that

the taxpayer in the present case cannot exclude the sum of $1450.40 from its gross income for federal income tax purposes. It would seem that patron membership in the taxpayer after February 8th, 1944, would not be retroactive to the period between November 1st, 1943, and February 8th, 1944, and that the profits received by the taxpayer during that period of time in legal effect represent profits from transactions with nonmembers, which under the applicable Iowa law are not subject to allocation as a patronage dividend. Deducting the said sum of $1450.40 from the $5913.14 allocated by taxpayer as a patronage dividend, leaves in question the status of the balance of the amount allocated as a patronage dividend in the sum of $4462.74, which was derived from profits of the taxpayer on business transacted with it by member patrons between February 8th, 1944, and October 31st, 1944. It is the view of the Court that the said sum of $4462.74 meets the conditions for exclusion contained in the Treasury Department rulings cited supra."

* * * * * * * *

"A closely related problem to the taxation of patronage dividends actually distributed, and a problem of particular importance in Iowa, is the taxability of those amounts which the cooperative merely credits to a patron's reserve account. Patronage dividends actually distributed, whether in the form of cash, capital stock, certificates of indebtedness or notes, as well as those net margins of the cooperative distributed to capital reserves and merely credited or allocated to patrons under a pre-existing obligation are presently excludable from gross income." (Underscoring added.)

It should not be assumed that all cooperative statutes impose a mandatory obligation on associations incorporated under them to make patronage refunds. The safer course is to have this obligation specifically imposed in the bylaws or marketing contract.

It has been pointed out that where an association is obligated to account to its members and patrons for all excess amounts remaining at the end of its fiscal year, such amounts are not technically patronage refunds or dividends at all; but are simply amounts that the association is obligated to pay to its members and patrons. This is particularly obvious in the case of a marketing cooperative using a marketing contract which requires the association to account to its members for all the proceeds derived from the sale of their commodities. Why, it is asked, should the last payment be regarded as a patronage refund or dividend any more than the first advance or payment?

MILK ASSOCIATION NOT EXEMPT AS A CIVIC LEAGUE

In Consumer-Farmer Milk Cooperative, Inc., v. Commissioner of Internal Revenue, 13 T.C. _____, decided on August 2, 1949, the question for decision was "whether petitioner is exempt from tax as a civic

league or organization under section 101 (8) of the Internal Revenue Code." Paragraph (8) of section 101 reads as follows:

> "Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes;"

The taxability of the cooperative was in question for the taxable year ended September 30, 1943. It paid income taxes for that year in the amount of $1,997.34, and an excess profits tax for the same year of $6,373.04. The Commissioner of Internal Revenue determined deficiencies in the declared value excess profits tax in the amount of $439.41 and in the excess profits tax in the amount of $23,821.32. The cooperative brought a suit for the purpose of recovering the income and excess profits taxes which it had paid on the ground that the cooperative was exempt as a social welfare organization under paragraph (8) of section 101 of the Internal Revenue Code.

It appears that the cooperative was organized in 1936 primarily by a group of welfare organizations and welfare workers to protect the public interest in milk distribution and milk regulation. "Any consumer is eligible to become a member of petitioner upon the payment of a 25-cent membership fee. Associations of farmers with whom petitioner has contracted for the supply of any part of the commodities which it distributes are also eligible for membership. The membership fee for such association is 25 cents for each of its farmer members. The membership fee of both consumers and farmers was collectible out of patronage dividends, at the discretion of the board of directors."

"Consumers must turn in dividend vouchers showing purchases amounting at least to $5 in the dividend year before being entitled to claim and receive dividends. Unclaimed declared consumer dividends are canceled and trasnferred to the general reserve fund one year after declaration. Petitioner's consumer dividend vouchers are approximately the size of the top of a bottle of milk and are a part of, and are separable from, the cardboard container of the milk. Farmer members, however, receive their dividends promptly without restrictions. After its first full year of operation the directors of petitioner decided to pay a refund or patronage dividend of 15 cents per 100 quarts of milk purchased from petitioner and 7½ cents per 100 quarts of milk furnished by the farmers to petitioner. Patronage dividends for its fiscal year 1943 were declared by petitioner at the rates above stated."

The association engaged in a number of activities which it regarded as helpful to the milk industry both from the standpoint of farmers and consumers. Among other things it opposed retail price fixing on the ground that it destroyed competitive conditions. It advocated the elimination of grading milk sold in New York City into Grades A and B,

and argued that there was no valid reason for the existence of a price differential between these grades. In 1940, the Board of Health of New York City issued a regulation establishing a single grade of milk known as "Approved Milk."

The cooperative engaged in a number of other activities which it regarded as beneficial from the standpoint of producers and consumers.

"For the taxable year ended September 30, 1943, petitioner deducted from its gross income the sum of $25,920.88 for declared rebates or patronage dividends to consumer patrons. Only $871.05 of the total amount so declared was paid. The remainder lapsed as dividends and was converted into petitioner's general reserve fund. Respondent determined that the amount of $25,049.83 of such declared dividends was not deductible for tax purposes. Petitioner waived its assignment of error as to that determination." (Underscoring added.)

The opinion of the Court holding that the cooperative is not eligible for exemption under paragraph (8) of section 101 of the Internal Revenue Code and upholding the action of the Commissioner of Internal Revenue follows:

> "Hill, Judge: Petitioner claims exemption under section 101 (8) as a civic league 'not organized for profit but operated exclusively for the promotion of social welfare.' The respondent contends that petitioner fails to meet the requirements of the statute.
>
> "The fact that petitioner was in a business which is ordinarily carried on for profit or that it was formed to make profit is not necessarily fatal to its claim, Debs Memorial Radio Fund, Inc. v. Commissioner, 148 Fed. (2d) 948, unless the facts disclose that a substantial portion of its net earnings was distributed or distributable to its members during the taxable year involved. In that event it could not be said that petitioner operated exclusively for the promotion of social welfare or for 'charitable, educational, or recreational purposes.' Sec. 101 (8), Internal Revenue Code.
>
> "We have found as a fact that petitioner was organized for a profit-making purpose, despite the statement in the certificate of incorporation that it was formed 'for mutual help, not conducted for profit.' Helen Hall, one of its founders and directors, testified as follows at the trial:
>
> > "Q. It was not your idea that milk should be sold to the public without a profit being made?
> >
> > "A. No.
> >
> > "Q. It was only to have a reasonable profit?
> >
> > "A. That is right.

"On brief petitioner requested the following finding of fact: '* * * All of the petitioner's operations are intended to return a fair profit, without any price-cutting below cost. * * *'

"The facts also show that a substantial portion of petitioner's net earnings was distributed or distributable for purposes other than social welfare. Petitioner's bylaws provide for the distribution of 'net earnings from the operation of the business' in the form of patronage dividends 'to consumer members and to producer members.' Meyer Parodneck, petitioner's president and another of its directors, stated that petitioner was not formed to operate on a price-cutting basis, but followed a cooperative principle of selling at the lowest possible retail rates and dividing the profits among the members in proportion to the amount of milk that had been sold to or purchased from petitioner. The foregoing statement might indicate a contention on the part of petitioner that it was exempt from tax as a cooperative under section 101 (12), notwithstanding its disavowal of such claim. If petitioner is advancing such contention, we direct attention to the fact that neither section 101 (12) nor any other provision of the revenue law exempts from tax a consumer's cooperative. However, assuming arguendo, that petitioner may properly contend that it is exempt from tax as a consumers' cooperative, it has not brought itself within the requirements of law providing for tax exemption as a cooperative.

"It appears that all of the patronage dividends declared payable to the producer (or farmer) members from 1943 earnings were paid. It also appears that less than 3 per cent of the dividends declared payable to consumer members out of earnings for such year was paid. Regarding dividends declared payable to consumer patrons, the facts show (1) that such declared dividend was 15 cents per hundred quarts of milk purchased during the dividend year, (2) that to entitle a consumer patron to claim and receive a dividend he must separate from the cardboard milk container a voucher for each quart of milk purchased and present it as proof of his purchase, (3) for each 100 vouchers so presented the patron would be entitled to a 15-cent dividend, less a 25-cent membership fee, and (4) petitioner canceled all such unclaimed dividends after the lapse of one year. In view of the restrictions as to payment of dividends to consumer patrons, it is small wonder that, of the $25,920.88 of dividends declared payable to them from 1943 earnings, only $871.05 was claimed and paid. The record shows that the total amount of dividends declared payable to consumers for the fiscal years 1939 to 1943, inclusive, amounted to $39,922.53 and of this amount only $3,050.25 was paid. The result is that at the end of the fiscal year 1943 petitioner had a net worth of $15,211.18. This net worth represents a surplus from earnings. The record does not disclose the amount of net earnings for the fiscal year 1943. It does not disclose the amount of such earnings placed in the general reserve. It does appear that no part of such earnings was put into the fund for cooperative education in the fiscal year 1943. The record does not disclose the proportion of the net earnings in 1943 which was declared payable as dividends to

patrons, or what amount, if any, of the net earnings was not disposed of as above indicated.

"Neither petitioner's certificate of incorporation nor its bylaws contains any statement concerning the distribution of its surplus. We believe the members of petitioner are the equitable owners of the surplus, as are the stockholders of an ordinary corporation, and that upon dissolution any surplus would be distributable to them. In any event, since section 22, New York's Co-Operative Corporation Law (McKinney's Consolidated Laws of New York, vol. 10 (a)) provides that surplus shall be distributed in accordance with the articles of incorporation or bylaws, the members, by amending the bylaws, could provide for the distribution of any surplus to themselves.

"We believe, therefore, that petitioner has not proved that it was not operated for profit, but exclusively for the promotion of social welfare.

"The stated conclusion is further fortified by a consideration of the burden and impracticability of complying with the conditions upon which consumer dividends are payable. It will be observed that only a comparatively insignificant portion of the dividends declared payable to consumer patrons was paid. We think it inescapable that petitioner anticipated that result, since under the provision of the bylaws respecting dividends to consumer patrons no other result could reasonably have been intended. We think, therefore, that it was not petitioner's expectation or intention that the main portion of the dividends declared payable or distributable to consumer patrons would be paid.

"Petitioner made no door-to-door deliveries of milk and apparently had no arrangement with consumers to take a certain quantity of milk daily or on any other time basis. It had no record showing who were its consumers or how much milk any consumer purchased during the year. The consumer went personally to the retail milk station and purchased and paid for each quart of milk when purchased. Obviously, petitioner had no subscribing and contract consumers. In declaring dividends for consumer patrons petitioner could only declare a total amount determined by the total quantity of milk sold during the fiscal year. It did not and could not declare a patronage dividend in a definite amount to any individual consumer patron. We think it improbable that petitioner expected or intended that more than a negligible number of its consumer patrons would tear off, hoard during the year, and present purchase vouchers for the meager dividend of 15 cents per hundred quarts, less a 25-cent membership fee. Also, we think it improbable that petitioner contemplated or intended that it would be put to the task of counting fifteen million (the number of quarts of milk sold in 1943) vouchers in individual consumer lots to determine to whom and in what amounts the declared dividends were to be paid.

"The obvious practical result of the operation in respect to consumer dividends was that petitioner built up a substantial net surplus out of its earnings which was not distributable as patronage dividends, but was, in our opinion, distributable in case of dissolution to petitioner's members as equitable owners. We think, however, that under the facts here the distribution of so-called patronage dividends was a distribution of profits to the members who received them. Industrial Addition Association, 1 T.C. 378; affd., 149 Fed. (2d) 294; see also Automobile Club of St. Paul, 12 T.C. _____ (June 23, 1949). See Better Business Bureau of Washington, D. C., Inc. v. United States, 326 U.S. 279.

"Petitioner maintains, however, that it was not organized for profit, but exclusively for the promotion of social welfare within the meaning of the section involved. It states under this argument that 'the major purpose of the petitioner [was] to increase the consumption of milk in low income families by passing on the economies of a special type of distribution.' It points out the many reforms it was interested in, such as eliminating grading of milk in New York City, and distributing milk in paper cartons at the same price as bottled milk. It carried on educational programs among farmers and consumers alike. As shown in our findings, however, only a small percentage of petitioner's income was set aside each year for educational purposes and after 1942 no additional sums were added to this fund. And as indicated above, petitioner also operated for a return of profit which was or might become distributable to its members otherwise than as so-called patronage dividends, and, therefore, we can not agree with petitioner that it was operated exclusively for social welfare.

"The cases which petitioner cites in support of its argument are distinguishable. In Debs Memorial Radio Fund, Inc. v. Commissioner, supra, the profits of the taxpayer were used for its ultimate purpose of maintaining a free public forum for educational, cultural, and social services, 'without financial gain to any individual.' The taxpayer was prohibited by its bylaws from using profits or surplus as dividends. In United States v. Pickwick Electric Membership Corporation, 158 Fed. (2d) 272; Hanover Improvement Society, Inc. v. Gagne, 92 Fed. (2d) 888; and Garden Homes Co. v. Commissioner, 64 Fed. (2d) 593, the courts found as a fact that the taxpayers were not organized for profit.

"It follows that respondent did not err in his determination. Decision will be entered under Rule 50." (Underscoring added.)

It should be noted that the Court specifically pointed out that no provision of the Internal Revenue Code provides for the exemption of a consumer cooperative.

Apparently one of the reasons that moved the Court to hold that the cooperative did not qualify for exemption under paragraph (8) was because, at least in dissolution, the members or stockholders would be entitled to

have the assets distributed among them after the payment of any debts or obligations. This case directs attention to the fact that the cooperative character of a cooperative may be affected by the manner in which its assets may be distributed in liquidation. The Court was of the opinion that the organization was organized for profit despite the statement in its articles of incorporation to the contrary. Likewise, the Court was of the opinion that the cooperative was not "operated exclusively for the promotion of social welfare." This case shows that statements declaring that an association is operating on a nonprofit basis are not controlling, but that on the contrary, the actual facts determine.

Attention is also called to the fact that in computing taxes due by this cooperative, the patronage refunds paid to farmers and patronage refunds actually distributed to consumer patrons were excluded, with the concurrence of the Bureau of Internal Revenue. The exclusions were made, although apparently there was no firm obligation to pay patronage refunds. The Tax Court, however, said:

> "We think, however, that under the facts here the distribution of so-called patronage dividends was a distribution of profits to the members who received them." (Underscoring added.)

The foregoing quotation indicates that if the Bureau had refused to permit the association to exclude the patronage dividends that were actually paid in cash, the Tax Court would have upheld the action of the Bureau.

LIABILITY FOR ANNUAL MEMBERSHIP DUES

In the case of Constructors' Association of Western Pennsylvania v. Furman, decided by the Superior Court of Pennsylvania, 67 A. 2d 590, it appeared that the association brought suit against the defendant for $1,233.33, representing annual membership dues for 1941 to 1946. The jury on the trial of the case found in favor of the defendant, and the association then appealed. It apparently was the contention of the defendant that he had an oral understanding at the time he signed the application for membership in the association that he was not to pay any dues. In reversing the Trial Court, the Superior Court said in part:

> "On April 15, 1935 defendant signed the following: 'I hereby make application for membership in the Constructors Association of Western Pennsylvania and when accepted agree to comply with the Constitution and By-Laws of the Association and such rules and regulations as may be regularly adopted for its government and operation.' He was accepted as a member by the board of governors on May 8, 1935."
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> * * * * * * *
>
> "The application was defendant's offer to become a member of the association under the terms of its by-laws; the acceptance of his offer formed a contract; and the by-laws by reference became the terms of the contract. Elliott v. Lindquist, 356 Pa. 385, 52 A. 2d 180,

169 A.L.R. 1369, approving Constructors Ass'n of W. Pa. v. Seeds, 142 Pa. Super. 59, 61, 15 A. 2d 467; Gordon v. Tomei, 144 Pa. Super. 449, 19 A. 2d 588; Burrill v. Dollar Savings Bank, 92 Pa. 134, 37 Am. Rep. 669; Susquehanna Ins. Co. v. Perrine, 7 Watts & S. 348. Cf. Barker v. Bryn Mawr College, 278 Pa. 121, 122 A. 220; Bulakowski v. Phila. Saving Fund Soc., 270 Pa. 538, 113 A. 553; Philadelphia v. Jewell, 135 Pa. 329, 19 A. 947.

"The by-laws are complete and entire, and their terms import a complete legal obligation in respect to the payment of dues without any uncertainty as to the amount of the dues or of any other duty imposed upon the members. The alleged parol agreement related to dues and other pecuniary obligations and that subject is exhaustively and completely covered by the written by-laws. Fraud, accident or mistake was not alleged. Accordingly, under Gianni v. Russell & Co., Inc., 281 Pa. 320, 126 A. 791, testimony of prior negotiations or of a contemporaneous agreement was inadmissible." (Underscoring added.)

As shown in the foregoing quotation, the Court held that the defendant had specifically contracted to be bound by the bylaws of the association, and that therefore his liability to pay annual dues was squarely based on a contract to do so. Of course, the bylaws of an association, like any other document, could be made a part of an application for membership.

It should be remembered that a member of an association is bound by all valid bylaws. In other words, the effectiveness of a valid bylaw is not determined by the fact that a member has contracted to be bound by the bylaws of an association. One of the distinguishing characteristics of bylaws is that they are binding on all members of an association, including those who may have opposed their adoption. [See Iowa State & Savings Bank v. City National Bank, 106 Neb. 397, 183 N.W. 982; Kelly v. Republic Building & Loan Association (Tex. Civ. App.), 34 S.W. 2d 924.] On the other hand, there can be no contract unless at least two persons have assented thereto.

Not all provisions that are sometimes included in so-called bylaws are valid as bylaws. If a proposition that is covered in a so-called bylaw may not lawfully be covered in a bylaw, it is not effective, at least as against those who have not assented thereto. An invalid bylaw as such creates no liability, but if not opposed to public policy it is generally enforced as a contract between the members and between the corporation and its members. [See Strong v. Minneapolis Automobile Trade Ass'n, 151 Minn. 406, 186 N.W. 800; New England Trust Co. v Abbott, Exr., 162 Mass. 148, 38 N.E. 432, 27 L.R.A. 271; Searles v. Bar Harbor Banking & Trust Company, 128 Me. 34, 145 A. 391, 65 A.L.R. 1154.]

UNINCORPORATED ASSOCIATION - MEMBERS LIABLE FOR DEBTS

In the case of Case, et al. v. Kadota Fig Association of Producers, et al., 207 P. 2d 86, it appeared that this unincorporated association of producers had filed a cross complaint in a suit that had been entered against the association. It prevailed on its cross complaint and obtained

a judgment on which execution issued, and under which property of the plaintiffs was seized. On appeal the judgment in favor of the association on its cross complaint was reversed because a cross complaint was held to have the same status and standing as an original complaint; and on account of this fact it was held that the association, under the law of California, could not maintain an action in its own name. In this connection, the Court said:

> "It is the rule in this state that persons associated in business under a common name may be sued by such common name, Section 388, Code of Civil Procedure; Jardine v. Superior Court, 213 Cal. 301, 2 P. 2d 756, 79 A.L.R. 291, but that this relaxation of the common law rule applies only to associated defendants, whereas associated plaintiffs still have to sue in their individual names. Holden v. Mensinger, 175 Cal. 300, 305, 165 P. 950; Ginsberg Tile Co. v. Faraone, 99 Cal. App. 381, 384, 278 P. 866; Agricultural Club v. Hirsch & Son, 39 Cal. App. 433, 435, 179 P. 430, 7 C.J.S., Associations, § 12, p. 35." (Underscoring added.)

In view of the fact that the judgment in favor of this unincorporated association was reversed, a liability arose to the plaintiffs in the original action because of the fact that their property had been levied upon. In this regard, the Court said:

> "As a rule a party whose money has been taken under a judgment which is thereafter reversed is entitled to restitution of the amount taken with interest. Section 957, Code Civil Procedure; Restatement of Restitution, sec. 74; Ward v. Sherman, 155 Cal. 287, 291, 100 P. 864; Levy v. Drew, 4 Cal.2d 456, 459, 50 P.2d 435, 101 A.L.R. 1144. However, as no final decision on the merits is given and it is conceded that at any rate certain amounts are due plaintiffs in the cross-actions we think it preferable, rules of equity being applicable, that the amounts be paid into court to abide final disposition and it will be so ordered. It is true that individual members of an unincorporated association organized for profit are individually liable for the obligations of the association contracted during their membership. Burks v. Weast, 67 Cal. App. 745, 751, 228 P. 541; Webster v. San Joaquin Fruit etc. Ass'n, 32 Cal. App. 264, 162 P. 654, 7 C.J.S., Associations, § 32, pp. 76-77; Wrightington, Unincorporated Associations, etc. secs. 12, 20, 24. But the liability for restitution was only caused by the execution on December 18, 1947, and only those who were members of Kadota at that time are individually liable. In case of dispute their identity will have to be established by the court below." (Underscoring added.)

This case well illustrates the handicaps and disadvantages under which an unincorporated association operates. For a general discussion of such associations, see "Legal Phases of Cooperative Associations," FCA Bul. 50, page 293.

Under the law of California, as pointed out in the case under discussion, a suit may be maintained against an unincorporated association in the

name of the association. But such an association in California may maintain an action only if it is brought in the name of all the members of the association, and in the absence of a statute it is believed that this is the general rule.

The members of the association in the instant case who were members at the time the property of the plaintiffs in the action in which the association obtained a judgment against them on its cross-complaint was seized on execution were held to be liable for the damages suffered by the plaintiffs. In general the liability of the members of an unincorporated association is the same as that of partners. See Houghton v. Grimes, 100 Vt. 99, 135 A. 15.

In the absence of a statute, an unincorporated association is ordinarily incapable as an organization of taking or holding title to property, either real or personal, in its own name. See Idaho Apple Growers Association v. Brown, 50 Idaho 341, 293 P. 320, 51 Idaho 540, 7 P. 2d. 591.

CREDITOR OR STOCKHOLDER - INTEREST OR DIVIDENDS

In the case of Jordan Company v. Allen, 85 F. Supp. 437, the question for decision was whether disbursements that the company had made on so-called debenture stock were dividends or interest. The company contended that they were interest, and hence were deductible in computing its income taxes. In this connection, the Court said:

> "The sole question involved in this case is whether the payments made to the holders of the Debenture Stock of The Jordan Company in 1940, 1941, 1942, 1943 and 1944 were in fact payments of interest on outstanding obligations as contended by the taxpayer or dividends paid on invested capital as determined by the Commissioner. If the payments were actually interest, they are deductible under Section 23(b) of the Internal Revenue Code, 26 U.S.C.A § 23(b). On the other hand, if they were in fact dividends, they are not deductible.
>
> "Generally speaking, those securities which we have come to consider as typical stocks and typical bonds are readily distinguishable. But with the increasing complexity of business organization has come an ever growing number of securities which fall between the extremes represented by the typical stocks and bonds. These issues have features common to both stocks and bonds and virtually defy positive classification." (Underscoring added.)

In holding that the disbursements made on account of the debenture stock were dividends and not interest, and hence that the amounts thereof were not deductible in computing the income taxes of the company, the Court said in part:

> "In general, the cases hold that the answer depends on what the payments in fact are. As decided by the Fifth Circuit and consistently followed by other courts, the question is ' " not what the payments

are called, but what in fact, they are"; and that if the evidence taken as a whole shows a relation of debtor and creditor, "the payments made on account of that relation, will be interest, no matter how called, while if taken as a whole, the evidence shows a stockholding relation, the payments made will be dividends, equally no matter how called."' Commissioner of Internal Revenue v. J. N. Bray Company, 5 Cir., 126 F. 2d 612, 613; U.S. v. South Georgia Rwy Co., 5 Cir., 107 F. 2d 3; United States v. Title Guarantee & Trust Co., 6 Cir., 133 F. 2d 990."

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"Though the courts have refused to lay down a precise formula to be applied, they have repeatedly set forth certain factors or criteria which they considered significant in arriving at the true nature of the securities involved. While most courts stress the same factors, no one has been relied on as a determinative factor. Those usually considered include: 1. Treatment by the parties; 2. Maturity date and right to enforce collection; 3. Rank on dissolution; 4. Uniform rate of interest payable or income payable only out of profits; 5. Participation in management and the right to vote." (Underscoring added.)

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"Finally, and of utmost significance, is the question of maturity date and the right to enforce payment of the principal sum by some appropriate legal remedy. The Fifth Circuit has repeatedly held that the existence of a fixed maturity date for the principal sum, together with a right to enforce payment of said sum as a debt in case of default, is the most significant, if not the essential feature of a debtor and creditor as opposed to a stockholder relationship. U. S. v. South Ga. Ry. Co., 5 Cir., 107 F. 2d 3. This view has been upheld in other jurisdictions. Jewel Tea Company v. U. S., 2 Cir., 90 F. 2d 451, 112 A.L.R. 182; Commissioner of Internal Revenue v. H. P. Hood & Sons, Inc., 1 Cir., 141 F. 2d 467. As stated by the Fourth Circuit in Brown-Rogers-Dixson Co. v. Commissioner of Internal Revenue, 122 F. 2d 347, 350, in which the certificate was almost identical with the one here involved, 'it has been repeatedly held that one of the fundamental characteristics of a debt is a definite determinable date on which the principal falls due.' In the Hood case [141 F. 2d 470], cited above, the court said that the existence of a fixed maturity date at which time the holder could demand payment regardless of net earnings was 'the essential feature of the debtor-creditor relation.'

"In this case, the obligation set forth in the debenture stock certificate clearly had no maturity date. There was no time set forth in the certificate or prescribed in the charter or by-laws at which the holders could demand payment of the principal sum. Nor was there any method provided by which such payment could be forced. As was said by Judge Learned Hand in the Jewel Tea Case, supra [90 F. 2d 453], 'there was no time fixed when the holders could demand their money; they were at the mercy of the company's

fortunes and payment was merely a way of distributing profits.'" (Underscoring added.)

As pointed out in the foregoing case, the question of whether amounts paid out by a taxpaying corporation are dividends or are interest must be determined on the facts of each particular case. It would appear from the decisions of the courts to date that it would be an unusual case indeed in which disbursements made by a corporation would be held to be interest if the security on account of which they were paid did not have a maturity date. In other words, interest is paid on indebtedness, and a common, if not a controlling, factor in determining if indebtedness exists is whether the security in question has a fixed maturity date. If the security does not have a maturity date, it strongly suggests that it is in the nature of stock and not indebtedness.

Agricultural cooperative associations issue certificates of indebtedness and forms of certificates other than certificates of stock. In the case of a nonexempt association, the rules for determining if disbursements made by an association are in the nature of interest or in the nature of dividends are the same rules that are applicable in the case of an ordinary corporation. Of course, if disbursements are dividends, they must be restricted in amount if the association is to be eligible for exemption.

The foregoing case and others that are similar in principle emphasize that a corporation, cooperative or otherwise, may have capital, without the capital being evidenced by certificates of stock. Of course, the common and usual way in the case of a stock cooperative is to have its capital evidenced by certificates of stock, but this is not the only way by which capital may be evidenced; or to put the matter somewhat differently, the fact that certain money in the hands of a corporation is not evidenced by certificates of stock is not conclusive on the question of whether the money in question is or is not capital. For instance, paid-in surplus is, under the regulations of the Bureau of Internal Revenue specifically treated as capital. (See section 19.22(a)-17 of Regulations 103 issued by the Bureau of Internal Revenue.)

COOPERATIVE APARTMENT HOUSE

In the case of Glennon v. Butler, 66 A. 2d 519, it appeared that the Westmoreland Cooperative Association was incorporated under the Cooperative Association Act for the District of Columbia (District of Columbia Code 1940, Title 29, Section 201, et seq.) and purchased an apartment house. The plaintiff "purchased" an apartment from the cooperative association and then filed an eviction suit against the occupant of the apartment in order that he might obtain possession thereof. The Municipal Court of Appeals for the District of Columbia reaffirmed its prior holding that one who had "purchased" an apartment in a cooperative apartment house, through becoming a member of the cooperative association and meeting the other usual requirements, had the status of a landlord or owner for the purpose of maintaining an eviction action. One of the contentions of the defendant was that the cooperative association

was not entitled as a corporation to manage and operate real estate in the District of Columbia. In answering this argument, the Court said:

> "Appellant's first contention is that the Westmoreland Cooperative Association as a corporation cannot, for the sole purpose of managing and operating, own real estate in the District of Columbia. This argument must fail. The Cooperative Associations Chapter of our Code authorizes such organizations 'to engage in any one or more lawful mode or modes of acquiring, * * * operating, * * * exchanging, or distributing any type or types of property * * * for the primary and mutual benefit of the patrons of the association * * * as ultimate consumers.' They are specifically authorized 'to acquire, own, hold, sell, lease, pledge, mortgage, or otherwise dispose of any property incident to its purposes and activities.' And a later section provides that no law conflicting or inconsistent with the provisions of the particular chapter is to be construed as applicable to these cooperative associations.
>
> "This argument must fail for the additional reason that it is a collateral attack upon the creation and existence of the cooperative, and such alleged want of capacity 'to own and dispose of real estate can only be asserted by the State.' It cannot be asserted by parties to a private dispute." (Underscoring added.)

As shown in the foregoing quotation, the Cooperative Association Act of the District of Columbia specifically authorized the ownership by a cooperative association of any type of property "for the primary and mutual benefit of the patrons of the association . . . as ultimate consumers." In other words, the so-called purchasers of the apartments were treated and regarded as ultimate consumers.

CONTRACTS MADE BY AGENTS

In the case of Lee v. Melvin, et al., decided by the Supreme Court of Florida, 40 So. 2d 837, the following self-explanatory statements of law are made:

> "'When plaintiff in a civil action seeks to recover upon a contract alleged by him to have been made with the defendant through the latter's agent, the burden of proof is upon plaintiff to show the authority of the agent for making the contract.' Foye Tie & Timber Co. v. Jackson, 86 Fla. 97, 97 So. 517.
>
> "'One seeking to hold corporation liable on officer's or agent's act or contract has burden to show authorization or ratification.' E. O. Painter Fertilizer Co. v. Boyd, 93 Fla. 354, 114 So. 444.
>
> "'The burden rests on one who seeks to hold a corporation liable for an act, or on a contract, of an officer or agent to show that act or execution of contract was duly authorized or that it was properly ratified.' Vassar v. Smith, 134 Fla. 346, 183 So. 705." (Underscoring added.)

In any instance in which a cooperative association contracts with a third person, and the contract of that person is signed by an agent, the cooperative association should be in a position to establish that the agent was authorized to act for and on behalf of the corporation or person for whom he purported to act. If the so-called agent was not authorized to act, and the person or corporation for whom he attempted to act did not later in some way ratify the contract, then the cooperative association would be unable legally to enforce the contract.